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**The Cash Flow Classification of Payments and Receipts  
Associated with the Termination of Interest Rate Swaps**

**By Eugene E. Comiskey and Charles W. Mulford**

**EXECUTIVE SUMMARY**

In this research report we discuss (1) why firms swap interest payments, (2) the essentials of swap accounting, (3) the reasons for swap terminations, (4) swap-termination accounting, and (5) the classification of cash receipts and payments from swap terminations. The study also includes company input on cash flow classification decisions and recommendations for GAAP changes.

There is significant diversity in the cash flow classification of payments and receipts arising from the termination of interest rate swaps. We find evidence that both an operating and a financing designation are often used. Differences in the nature of the underlying transactions or in the circumstances surrounding them do not explain the diversity in reporting practices noted. Given that interest rate swaps are motivated primarily by the desire to manage interest rate risk, we think that an operating designation is the more appropriate classification. We identify a sample of firms that employ a financing designation for swap termination payments and receipts and adjust reported operating cash flow to include them. Significant changes to operating cash flow are noted in several cases.

August, 2007

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**Georgia Tech Financial Analysis Lab**

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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## **The Cash Flow Classification of Payments and Receipts Associated with the Termination of Interest Rate Swaps**

**By Eugene E. Comiskey and Charles W. Mulford**

### **Introduction**

This study builds on a recurrent theme of the Financial Analysis Lab - problematic classifications within the statement of cash flows. To set the stage for this investigation, we illustrate the two most common interest-rate swaps. In addition, to provide the context for the study, we discuss (1) why firms swap interest payments, (2) the essentials of swap accounting, (3) the reasons for swap terminations, (4) swap-termination accounting, and (5) the classification of cash receipts and payments from swap terminations. The research study also includes company input on cash flow classification decisions and recommendations for GAAP changes.

Interest-rate swaps (hereafter simply swaps) are a popular financial derivative that are frequently used to hedge risk associated with interest-bearing debt. The two most common swaps involve either the exchange of variable interest payments for fixed or fixed interest payments for variable. For hedge-accounting purposes, the swaps are classified as either cash-flow hedges (for swaps of variable interest payments for fixed) or fair-value hedges (for swaps of fixed interest payments for variable).

*Cash Flow Hedge*--Party A with variable (floating) rate debt agrees to pay interest to Party B at a fixed rate on a specified amount (the notional amount). In exchange Party B pays interest to Party A at a variable rate on the same notional amount. Party A continues to be responsible for the interest on its variable rate debt as well as its principal upon maturity. In practice, these two streams, the payment of A to B and of B to A, are offset and a net *settlement* payment is made by one of the two parties to the other. Party A achieves a cash-flow hedge by converting its interest payment obligation to a fixed rate and eliminates the risk associated with future fluctuations in interest rates.

*Fair Value Hedge*--Party C with fixed-rate debt agrees to pay interest to Party D at a variable rate on a specified amount (the notional amount). In turn, Party D agrees to pay interest at a fixed rate on the same notional amount to Party C. Party C also continues to be responsible for the payment of both the interest and principal on its debt. Party C achieves a fair-value hedge by converting its fixed-rate interest payments to a variable rate payment obligation, which eliminates fluctuations in the fair value of its debt. Special hedge accounting, illustrated later, is applied under SFAS No. 133 in the case of both cash-flow and fair-value hedges.<sup>1</sup>

### **Why Swap?**

The short answer to “Why swap?” is to manage the risk associated with interest-bearing debt. A firm with fixed-rate debt is exposed to changes in the fair value of its obligations as interest rates fluctuate. As interest rates rise, the fair value of debt declines. The opposite occurs as interest rates decline. This exposure can be hedged with a fair-value swap, fixed to variable. A firm with

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<sup>1</sup> SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (Norwalk, CT: Financial Accounting Standards Board, 1998, paragraphs 20 to 35.

variable-rate debt faces fluctuations in its interest expense and associated interest payment cash flows as interest rates change. As interest rates rise, interest payments on variable-rate debt will increase. Declines in interest expense and interest payments will occur when interest rates fall. A swap classified as a cash-flow swap, variable to fixed, can hedge this exposure. The statement below, from a discussion of interest-rate risk in the 2006 annual report of Smurfit-Stone Container Corp. highlights these two types of exposure.

Smurfit-Stone Container Corp.

“A change in the interest rate of fixed rate debt will impact the fair value of the debt, whereas a change in the interest rate on the variable rate debt will impact interest expense and cash flows.”<sup>2</sup>

The Smurfit-Stone statement above highlights a feature that is central to understanding the differences between fair-value and cash-flow swaps: Changes in interest rates on fixed-rate debt increase or decrease the fair value of the debt. Alternatively, changes in interest rates on variable-rate debt affect the amount of interest expense and related cash payments but not the fair value of the debt.

Beyond the general goal of managing interest-rate risk, our review of about two hundred annual reports on Form 10-K reveals numerous different characterizations of why interest rate swaps are employed. While there is some redundancy, the listing in Exhibit 1 provides a richer view of what motivates firms to use swaps. Recurring themes of the entries in Exhibit 1 include reducing borrowing costs, changing the mix of fixed and variable-rate debt, reducing volatility in cash flows, mitigating changes in the fair value of debt, and in some cases complying with requirements to employ swaps as part of credit agreements.

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<sup>2</sup> Smurfit-Stone Container Corp., Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2006, p. 24.

**Exhibit 1: Company Characterizations of Why They Swap**

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1. Mitigate interest rate volatility
  2. Offset changes in the fair value of debt
  3. Achieve a better balance of fixed and variable rate debt
  4. Fix future interest payments
  5. Comply with requirements of a credit agreement
  6. Convert a portion of fixed rate debt to floating, with the objective of reducing overall borrowing costs
  7. Protect against changes in the fair value of fixed rate debt
  8. Mitigate exposure to changes in the fair value of fixed rate debt resulting from fluctuations in interest rates
  9. Benefit from future declines in interest rates
  10. Reduce overall borrowing costs
  11. Speculate on interest rate movements
  12. Alter the mix of fixed and floating rate debt
  13. Reduce future interest payments
  14. Hedge the variability of forecasted cash flows
  15. Reduce volatility of earnings and cash flows associated with interest rate changes
  16. Maintain a higher proportion of less expensive variable rate debt
  17. To increase the fixed portion of the Company's debt portfolio in response to changes in the interest rate environment
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**Swap Accounting Essentials**

As a financial derivative, swaps must be recorded on the balance sheet at their fair value under current GAAP (SFAS No. 133) requirements. This valuation may result in the recording of either an asset or a liability. Accounting for changes in the fair value of that asset or liability depends on whether or not the interest rate swap is accounted for as a hedge. In the absence of hedge accounting, all gains and losses on interest-rate swaps are taken to income currently. In contrast, hedge accounting, according to Pahler, “. . . is a special accounting treatment that achieves concurrent recognition (in earnings) on either (1) an immediate basis or (2) on a delayed basis, of counterbalancing gains and losses on both the hedging transaction and the related hedged item.”<sup>3</sup> Hedge accounting is designed to ensure the proper matching of the gains and losses on the hedging instruments and the hedged items, respectively. In the case of fair-value hedges, in order to achieve matching, SFAS No. 133 requires recognition of changes in the value of both the swap derivative and the hedged debt at the same time. With a cash-flow hedge, matching is achieved by deferring the gains and losses on the swap derivative and then amortizing those gains or losses as decreases or increases, respectively, in interest expense on the hedged item.

Some of the key requirements to qualify for the use of hedge accounting include formal documentation of: (1) The risk-management objective and strategy; (2) The identity of the hedging instrument and the hedged item; (3) The specific risk being hedged; (4) The method by which the hedge serves to reduce the targeted risk; and (5) How hedge effectiveness will be

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<sup>3</sup> Pahler, A. Advanced Accounting, 8<sup>th</sup> ed. (Mason, OH: Thomson/SouthWestern, 2003), p. 527.

assessed.<sup>4</sup> The key features of swap accounting are outlined below, with fair-value and cash-flow applications treated separately.

### Accounting for fair value hedges

In the case of a fair value swap, changes in both the value of the swap and the associated hedged debt are recorded. Where the hedge is perfectly effective, the changes in the fair value of the swap and the fair value of the debt offset each other, and there is no net income statement effect (Exhibit 2 summarizes the offsetting changes that cause the swaps to perform as hedges).

To illustrate the required accounting, assume that because of a decline in interest rates, a fixed-to-variable rate swap increases in value by \$5 million (interest paid at the floating rate is less than the interest received at the fixed rate). Accounting under SFAS No. 133 requires the following: (1) a revaluation of the swap to fair value (2) a revaluation of the hedged debt to fair value, and (3) the recording of the net swap cash payment settlement received or paid (assumed to be \$1 million received in this case) as a result of the difference between the fixed-rate interest received and the floating-rate interest paid.

- (1) Recording the increase in the fair value of the swap  
Increase in the swap derivative (an asset account) of \$5 million  
Increase in swap-related income (an income statement account) of \$5 million
- (2) Recording the increase in the fair value of the debt  
Loss from the increase in the fair value of the debt (an income statement account) of \$5 million  
Increase in the fixed-rate debt (a liability account) of \$5 million
- (3) Recording the net swap cash payment settlement  
Increase in cash (a balance sheet account) of \$1 million  
Decrease in interest expense (an income statement account) of \$1 million

The combination of items “1” and “2” above produce no net effect on earnings. The gain on the swap itself of \$5 million is exactly offset (a perfect hedge in this case) by the loss of \$5 million from the increase in the fair value of the fixed-rate debt. In addition, interest expense is reduced by \$1 million dollars because of the *net settlement* of the swap for the period, item 3 above. An example of elements 1 and 2 above is provided by the swap disclosures of TJX Companies. Unlike the example above, the TJX swap decreased in value because of an increase in the floating rate:

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<sup>4</sup> Much more detail on the requirements to qualify, both initially and on an ongoing basis, for hedge accounting is found in SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (Norwalk, CT: Financial Accounting Standard Board, 1998), paras. 20 – 35.



TJX Companies, Inc.

“At April 28, 2007, TJX had interest rate swap agreements outstanding with a notional amount of \$100 million. The agreements entitle TJX to receive biannual payments of interest at a fixed rate of 7.45% and pay a floating rate of interest indexed to the six-month LIBOR rate with no exchange of the underlying notional amounts. The interest rate swap agreements converted a portion of TJX’s long-term debt from a fixed rate obligation to a floating rate obligation. The fair value of the swap agreements outstanding at April 28, 2007, excluding net interest receivable, was a liability of \$3.3 million. The valuation of the derivative instruments results in an offsetting fair value adjustment to the debt hedged; accordingly, long-term debt has been reduced by \$3.3 million.”<sup>5</sup> Note that the net swap cash payment settlement amount for the swap was not disclosed.

(1) Recording the decline in value of the swap

Loss from the decline in the value of the swap (income statement account) of \$3.3 million

Liability recorded for the fair value of the swap (balance sheet account) of \$3.3 million.

(2) Recording the decline in the value of the debt

Decline in the fair value of the debt of \$3.3 million (balance sheet account)

Gain from the decline in the value of the debt (income statement account) of \$3.3 million

The role played by the hedge accounting illustrated above can be better understood by considering the outcome if the above swaps had not qualified as hedges. In this case the TJX example would call for only recording the change in the fair value of the swap. This results in a loss of \$3.3 million in the TJX income statement with no offsetting gain from a decline in the fair value of its debt. Recording (2) above is the key feature of hedge accounting in the case of fair-value swaps. Firms employing swaps normally want them to qualify for hedge accounting treatment because of the volatility in earnings introduced by an inability to record offsetting gains and losses.

**Accounting for cash flow hedges**

In the case of the cash-flow hedge, there is an absence of the ongoing symmetry present above with the fair-value hedge, i.e., in a fair-value hedge, the change in the value of the swap and the debt offset each other in the same reporting period. Asymmetry is a feature of the cash-flow hedge because only the change in the value of the swap is recognized. To achieve matching, gains and losses on the swaps are not recorded initially in an income statement account. Rather, their income effects are deferred in accumulated other comprehensive income, a component of shareholders’ equity. Subsequently, they are amortized (reclassified) into the income statement as an increase or decrease in the interest expense on the associated debt.

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<sup>5</sup> TJX Companies, Inc., Form 10-Q Quarterly Report to the Securities and Exchange Commission, April 28, 2007, p. 10.

AirGas Inc. provides an example of this amortization policy: “Over the next 12 months, the Company expects to reclassify \$275 thousand of deferred gains from accumulated other comprehensive income to interest expense as related interest payments that are being hedged are recognized.”<sup>6</sup>

In illustrating the accounting for the cash-flow hedge, the same increase in the fair value of the swap of \$5 million used in the case of the fair-value swap is assumed here as well. However, while a decline in interest rates resulted in an increase in the value of the fair-value swap, a gain on the cash-flow swap, a swap from variable to fixed, results from an increase in interest rates. Swapping into a fixed interest rate is beneficial when variable rates rise. With a cash flow hedge, accounting for the \$5 million change in the fair value of the swap requires the following adjustment:

- (1) Recording the increase in the fair value of the swap
  - Increase in the swap derivative (an asset) of \$5 million
  - Increase in accumulated other comprehensive income (a shareholders' equity account) of \$5 million

In the case of a cash flow hedge, there is no change in the fair value of the underlying hedged debt. That is, the underlying debt is a variable interest obligation whose interest payments change with interest rates, leaving the fair value of the underlying obligation unchanged. Accordingly, with no offsetting loss to be recorded on a change in the fair value of the underlying debt, the gain on the swap is deferred in accumulated other comprehensive income within shareholders' equity. It is then amortized into interest expense over the remaining term of the underlying debt.

Assuming that \$1 million is the proper amount to amortize in a subsequent year, the following adjustment would be recorded:

- (2) Recording amortization of a portion of the deferred swap gain
  - Decrease in accumulated other comprehensive income (an equity account) of \$1 million
  - Decrease in interest expense (an income statement account) of \$1 million

An increase in interest rates in a variable to fixed swap results in the receipt of a net swap cash payment settlement. Assuming that \$500,000 is the settlement payment received, the following adjustment would be recorded.

- (3) Recording the net swap cash payment settlement
  - Increase in cash (a balance sheet account) of \$500,000
  - Decrease in interest expense (an income statement account) of \$500,000

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<sup>6</sup> AirGas, Inc., Form 10-K Annual Report to the Securities and Exchange Commission, March 31, 2006, p. F-19.

A summary of the hedge behavior of the above fair value and cash flow swaps is provided in Exhibit 2. The symmetry of the fair-value hedge is evident in the offsetting gains and losses in the face of interest rate increases and decreases. The absence of symmetry for the cash-flow hedge is also evident from the lack of contemporary offsetting gains and losses.

### Exhibit 2: Hedging Behavior of Interest Rate Swaps

	Fair-Value Hedge		Cash-Flow Hedge	
	Debt Value	Swap Value	Debt Value	Swap Value
Interest rates increase	Decrease (gain)	Decrease (loss)	No change	Increase (gain)
Interest rates decrease	Increase (loss)	Increase (gain)	No change	Decrease (loss)

With this basic background on the accounting for swaps, up to the time of a termination, we turn to the reasons why swaps are terminated prior to their maturity, the associated accounting, and the key issue of how swap termination receipts and payments are currently being classified in the statement of cash flows.

### Motivations for Swap Terminations

There are a variety of reasons for the termination of a swap prior to its maturity. Some of these are stated explicitly in financial disclosures associated with the termination and others must simply be inferred from selected contemporaneous activities, e.g., the retirement of debt that was the target of the swap hedge. Five representative examples, with some redundancy, drawn from companies reviewed for this study are listed below:

1. “We terminated \$670 million of our interest rate swap agreements to lock in savings and received \$91.8 million” (ONEOK, Inc.).
2. “The company closed out all \$2.5 billion of interest rate swap agreements in order to lock-in favorable interest rates” (ConAgra, Inc.).
3. “[Swaps] were terminated prior to maturity to enable the Company to monetize, or realize, gains in the fair value of the swaps” (Pall Corp.).
4. “As a result of our call of all of our 8.50% Notes due 2006, in November 2004, we terminated five interest rate swaps used to hedge our interest rate exposure on the issue” (Citizens Communications, Inc.).
5. “In fiscal 2006, ATK made a cash tender offer for all of its . . . 8.50% Senior Subordinated Notes . . . ATK also terminated its three interest rate swaps associated with the 8.50% Notes . . .” (Alliant Techsystems, Inc.).

Our review of many swap terminations reveals that most swap terminations are the result of the retirement of the underlying debt. Beyond this, some firms terminate hedges that are in an asset position to lock in the cash value or to freeze a favorable interest-rate circumstance. On a limited

number of occasions we noted swaps being terminated because of modifications in credit agreements that removed mandates that required swaps to hedge, typically, floating rate debt.

### **Swap-Termination Accounting**

The accounting for swaps terminated prior to their maturity is affected by the classification of the swap-related hedge, fair value or cash flow, as well as other circumstances surrounding the hedges, e.g., is some or all of associated debt retired? The termination accounting is discussed separately for swaps that are used as fair-value versus cash-flow hedges.

Upon termination, a swap will be in either an asset or liability position. An asset position is the product of net cumulative gains on the swap, and a liability position results from net cumulative losses. The holder of a swap in an asset position will receive a cash payment from the counterparty equal to the current fair value of the swap. Similarly, a swap in a liability position will require a payment by the swap holder to the counterparty. A variety of circumstances surrounding the swap and the termination will call for different accounting treatments.

### **Accounting for the termination of fair value hedges**

Accounting for the termination of a fair-value hedge is relatively straight forward when the repayment of the debt underlying the swap is the reason for the swap termination. Cash will be received or paid based upon the valuation status of the swap contract. Examples of terminated swaps, where the associated debt is simultaneously repaid and where the debt is maintained, are provided and discussed below:

#### Swap termination with associated debt retired (CSK Auto Corp.)

“In July 2006, we paid \$11.1 million to terminate the swap agreement, representing \$10.4 million of a fair value liability and \$0.7 million of accrued interest. The \$10.4 million was recognized as a loss during the second quarter of fiscal 2006”<sup>7</sup>

The above terminated CSK fair-value swap was in a liability position in the amount of \$10.4 million. The associated debt was all repaid in July 2006. If the debt underlying the swap had not been repaid, then the termination payment of \$10.4 million would have reduced the carrying value of the debt (analogous to a debt discount) and would then have been amortized into interest expense over the remaining term of the debt. However, since the underlying debt was discharged, GAAP requires that the payment be recognized as a current expense and not deferred.

Jabil Circuit, Inc. provides an example of a swap termination where the underlying debt is not retired. Here, the swap termination payment serves to reduce the carrying value of the debt (again, analogous to a debt discount) and is then amortized over the debt's remaining term. The amortization involves the recording of interest expense that is offset in turn by an increase in the carrying value of the debt (as the unamortized discount is reduced).

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<sup>7</sup> CSK Auto Corporation, Form 10-K Annual Report to the Securities and Exchange Commission, January 29, 2006, p. 99.

(2) Swap termination with associated debt maintained (Jabil Circuit, Inc.)

“The interest rate swap was terminated on June 3, 2005. The fair value of the interest rate swap of \$4.5 million was recorded in long-term liabilities, with the corresponding offset recorded as a decrease in the carrying value of the 5.875% Senior notes on the consolidated balance sheet at the termination date . . . The \$4.5 million decrease to the carrying value of the 5.875% notes will be amortized through interest expense over the remaining term of the debt.”<sup>8</sup> (Note that the \$4.5 million recorded as a long-term liability was paid to the counterparty.)

**Accounting for the termination of cash-flow hedges**

As with fair-value hedges, any gain or loss that results from the termination of cash-flow hedges is included in income in cases where the underlying debt is repaid. Such gains and losses are deferred when the underlying debt remains outstanding. The examples below deal with both cases, i.e. debt repaid upon termination and debt maintained.

(1) Swap termination with associated debt retired (Felcor Lodging L.P.)

“In connection with the repayment of our \$290 million senior floating rate notes, we unwound (terminated) the floating to fixed interest rate swaps associated with these notes. Termination of these interest rate swaps resulted in a gain of approximately \$1.7 million, which was recorded in the fourth quarter of 2006.”<sup>9</sup>

(2) Swap termination with associated debt maintained (Waddell & Reed Financial, Inc.)

“On January 10, 2006, the Company terminated these forward interest rate swap agreements upon completion of its new offering in January 2006 of \$200 million in principal amount 5.60% senior notes due January 2011. In connection with the termination of the swap agreements, the Company received a net cash settlement of \$1.1 million. The Company’s gain on this transaction will be deferred in accumulated other comprehensive income and will be amortized into earnings as a decrease to interest expense over the five year term of the new notes.”<sup>10</sup>

In (1) above, the \$1.7 million received by Felcor Lodging is included as a gain in its current income statement. This is because the debt that was underlying this cash flow swap was retired. Hence, there is no basis for deferral of the gain and its amortization over future periods. In case (2), Waddell & Reed used the swap to hedge an expected new issue of debt. When the debt issue occurred and the swap was terminated, the \$1.1 million gain was deferred and will be amortized into earnings, reducing interest expense over the term of the new notes.

The treatment of the accounting for swap terminations, along with the other background, now puts us in a position to examine the classification of swap termination payments and receipts in the statement of cash flows.

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<sup>8</sup> Jabil Circuit, Inc., Form 10-K Annual Report to the Securities Exchange Commission, August 31, 2006, pp. 76-77.

<sup>9</sup> Felcor Lodging Limited Partnership, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2006, p. 70.

<sup>10</sup> Waddell & Reed Financial, Inc., Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2006, p. 68.

### The Classification of Swap Termination Cash Flows

As noted earlier, there is little or no GAAP focused directly on the classification of cash payments or receipts associated with swap terminations. At a very generic level, SFAS No. 95, calls for a financing classification for money borrowed and repaid. However, interest payments are classified into operating cash flows because interest is included in the determination of net income.<sup>11</sup> Because all cash received or paid in a swap termination either increases or decreases interest expense, an operating cash flow classification would appear to be in order under SFAS No. 95. Subsequent to the issuance of SFAS No. 95, the FASB received requests from firms to reconsider guidance in SFAS No. 95 that dealt with the classification of hedge-related cash flows. This original guidance stated that, “Each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item.”<sup>12</sup> The FASB responded in SFAS No. 104 with the following:

“This Statement also amends Statement No. 95 to permit cash flows resulting from futures, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged provided the policy is disclosed.”<sup>13</sup>

In addition, SFAS No. 104 spoke directly to the classification of cash flows associated with swap contracts:

“The Board concluded that cash flows from swap contracts should be included within the scope of this Statement . . . The Board also concluded that cash flows from an interest rate swap intended to effectively convert the interest rate of an asset or liability from variable to fixed or fixed to variable may be classified as operating cash flows consistent with the interest cash flows relating to the underlying asset or liability.”<sup>14</sup>

Under this clarification to SFAS No. 95, an operating classification for interest-rate swaps is permitted but not required. This change was no doubt helpful in classifying cash flows in some hedging situations. However, because of diversity noted in practice, SFAS No. 104 appears to have done little to address the classification of cash flows associated with swap terminations.

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<sup>11</sup> SFAS No. 95, *Statement of Cash Flows*, (Norwalk, CT: Financial Accounting Standards Board, 1987), para. 21.

<sup>12</sup> SFAS No. 95, footnote 4.

<sup>13</sup> SFAS No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions*, (Norwalk, CT: Financial Accounting Standards Board, 1989), Executive Summary.

<sup>14</sup> SFAS No. 104, para. 40.

### Classification in Practice

We studied the classification of cash payments and receipts associated with swap terminations by searching 10-K filings for 2006. The classifications for a representative sample of these firms are provided in Exhibit 3.

The most striking feature of the data in Exhibit 3 is the absence of consistency in classification of cash flows from the termination of the fair value and cash flow hedges. That is, the disclosures we reviewed for fair value swaps typically made an explicit connection between the employed swap and the hedged debt.<sup>15</sup> Since debt issues or repayments are classified into financing cash flows, one might expect the same treatment for the cash flows associated with fair-value swap terminations. However, for the fair value swaps, only 12 of the 22 swap settlements were classified into financing cash flow. On the other hand, the cash-flow-hedge disclosures tend to link the hedge to the future stream of interest payments.<sup>16</sup> Here, the expectation would be that an operating cash flow classification for swap termination cash flows would dominate. However, in this case, there were more classifications into financing cash flow (13) than into operating cash flow (9).

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<sup>15</sup> For example, “They (fair value hedges) therefore hedge the interest rate risk associated with our fixed rate debt obligations and hedge against changes in the fair value of our fixed rate debt due to market rate changes.” Kinder Morgan Energy Partners, Form 10-Q Quarterly Report to the Securities and Exchange Commission, March 31, 2007, p. 33.

<sup>16</sup> An example of this link to future interest payments: “The objective of the hedge was to offset the variability of cash flows relating to the interest payments on variable rate debt outstanding under the Company’s revolving credit facility.” Astec Industries, Form 10-K Annual Report to the Securities and Exchange Commission, December 31, 2006, note 15.



**Exhibit 3: Classifications by Hedge Type and Swap-Termination Cash Flows**

Company	Hedge Type		Classification	
	Fair Value	Cash Flow	OCF	FCF
AirGas	X			X
Alliant TechSystems	X		X	
ARVINMERITOR	X		X	
Asbury Auto Group*	X	X	X	
Brookdale Senior Living		X		X
Brandywine Realty Trust		X		X
CBRE Realty Finance		X		X
Coca-Cola Enterprises	X			X
Crown Castle International		X		X
CSK Auto	X		X	
Cytec Industries		X	X	
Dominion Homes		X		X
Dry Bulk Cape Holdings		X	X	
Exelon		X	X	
Felcor Lodging		X	X	
Foundation Coal		X		X
Fountain Powerboats		X		X
Healthcare Realty Trust	X			X
Host Hotels and Resorts	X			X
Huttig Building Products		X	X	
Jabil Circuit	X			X
JER Investors Trust		X		X
Multi-Color	X			X
National Rural Utilities	-	-	X	
Newell Rubbermaid	X		X	
NiSource		X	X	
New York Community Bank	X		X	
OMI		X	X	
ONEOK		X		X
Polo Ralph Lauren**	X	X		X
Regency Energy Partners		X	X	
Salem Communications	X			X
Sanmina-SCI	X			X
Schulman, A.	X		X	
Speedway Motorsports	X		X	
Spirit Finance		X		X
Stanley Works		X		X
Texas Industries	X			X
Toys "R" Us	X		X	
U.S. Concrete	X		X	
Valero Energy	X			X
Waddell & Reed Financial		X		X
Wolverine Tube	X			X
Wynn Resorts***	-	-	X	X
	22	22	19	25



**Exhibit 3 (continued)**

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OCF - Operating cash flow

FCF - Financing cash flow

\* Three swaps were terminated, two cash-flow hedges and one a fair-value hedge.

\*\* A fair-value hedge was terminated in fiscal 2006 and a cash-flow hedge in fiscal 2007

\*\*\* The terminated interest rate swap did not meet the SFAS 133 requirements for the use of hedge accounting.

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The 44 firms, in spite of the disclosure requirements of SFAS No. 104, provided little commentary on the classification of the cash flows associated with their interest rate swaps.<sup>17</sup> It is difficult to discern the logic behind this classification diversity in the absence of a disclosure of its classification policy. In the recent past we have found that useful insights can sometimes be obtained directly from company financial officers about the logic underlying their cash-flow classification decisions.<sup>18</sup> However, direct input seems to be more difficult to obtain subsequent to the issuance by the Securities and Exchange Commission of *Regulation Full Disclosure* (Reg. FD).<sup>19</sup> The limited responses we did receive provide some useful insights into these classifications decisions.

**Input from Practice**

We sent letters to about 40 firms that disclosed swap termination proceeds into either operating or financing cash flow. The small set of responses received is broken down in Exhibit 4 into cases where the termination cash flows were classified into financing and operating cash flow, respectively. Our inquiries asked for affirmation of the classification of swap-termination cash flows and also for the logic underlying the classifications within the statement of cash flows.

**Financing cash flow responses**

Response 1 of the financing cash flow responses provided in Exhibit 4 involves a cash-flow hedge and the classification is justified by the fact that the termination was prompted by a payment of the associated debt, with the payment itself being a financing transaction. Response 2, a fair value hedge, links the classification to the hedge of the fair value of debt. However, note the uncertainty surrounding this decision and the suggestion that in the future a similar swap might be considered a hedge of interest payments and be classified into operating cash flows. Response 3 simply reports following the majority practice of classifying swap-termination cash

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<sup>17</sup> SFAS No. 104 permits cash flows from derivative instruments used for hedging to be classified in the same category as the target of the hedge. However, there is a condition that this accounting policy be disclosed.

<sup>18</sup> For an example of a recent study that addresses the cash-flow classification, see the following Lab report: Eugene E. Comiskey and Charles W. Mulford, *Classification of Distributions Received from Unconsolidated Entities*, September 2006.

<sup>19</sup> Securities and Exchange Commission, *Selective Disclosure and Insider Trading, Regulation FD* (Washington, D.C., 2000).

flows into financing cash flows.<sup>20</sup> Finally, respondent 4 initially considered a classification into operating cash flow, but in the end decided on a financing cash flow classification. Key considerations were the linkage of the swap to a debt instrument, and the determination that a swap termination was neither operating nor sustainable. In addition, the counsel of a derivative specialist at a large accounting firm argued for a financing cash flow classification.

### **Operating cash flow responses**

Response 1 of the operating cash flow responses presented in Exhibit 4 is from a firm that changed its classification from financing cash flows to operating cash flows. The logic included the fact that the goal of the swap was to reduce interest costs, which are an operating cash flow item. In addition, a linkage was made between the periodic swap settlements (the payment or receipt for differences between the fixed and floating rates) and cash paid or received upon the termination of the swap. Response 2 is from a firm that does not classify its swaps as either fair value or cash flow hedges. The logic behind their operating-cash-flow classification is similar to that of response 1. Periodic swap settlements reduced this firm's interest expense. The receipt of proceeds from a swap termination has the same effect, reduces interest expense, and therefore is also classified with the swap settlement interest reduction, i.e., in operating cash flow. Moreover, the swaps are seen as quite different from conventional debt instruments. Response 3 sees a similarity between regular interest payments and the cash inflow from swap terminations. Even though response 3 involves a fair-value hedge, the position taken is that the swap is designed to control interest expense. Hence the swaps linkage is to an operating cash flow item. This response also makes a reference to SFAS No. 104.

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<sup>20</sup> We have a balanced number of swap terminations presented in Exhibit 3. However, in the large set of firms reporting swap terminations, a classification into financing cash flows is more common.

**Exhibit 4: Replies from Company Financial Officers about their Classification Decisions****Cash classified into financing cash flow****Response 1 (cash-flow hedge)**

“Since our Company does not authorize speculative hedges, the swap had to be terminated (the debt that was the hedge target was prepaid). Since this was a direct result of a financing activity (i.e., the repayment of debt), we felt it appropriate to classify the termination consistent with the cause.” (Tufco Technologies, CFO)

**Response 2 (fair-value hedge)**

“We determined that our interest rate swaps were considered a ‘hedge of the changes in fair value of the fixed-rate debt attributable to changes in the designated benchmark interest rate’ as described in Example 2 in Appendix B of SFAS No. 133. Therefore, the cash flows from the sale of the interest rate swaps were classified in the same category as the cash flows from the item being hedged (the underlying debt).”

“We base this classification using the guidance in SFAS 95 paragraph 14, footnote 4, which states: Cash flows from a derivative instrument that is accounted for as a fair value or cash flow hedge may be classified in the same category as the cash flows from the items being hedged.”<sup>7</sup>

“In the light of your question, we have reviewed our past accounting policy. If we entered into a swap today, we may not designate our swap as a hedge of the fair value of our debt, but rather of our interest payments. In this situation, we would classify the cash flows in operating activities.” (Nordstrom, Inc., Financial Reporting Manager).

**Response 3 (fair-value hedge)**

“We report proceeds from the settlement of interest rate swaps in the financing section of the statement of cash flows, consistent with your (the authors) finding that this is how most companies treat this proceeds.” (Clorox, V.P. and Assistant Controller)

**Response 4 (fair-value hedge) summary of a phone conversation**

“We initially believed cash associated with swap terminations to be operating cash flow. However, we reconsidered and focused on the association of the swap to a debt instrument as well the fact that the cash inflows and outflow associated with swap terminations are neither operating in nature nor sustainable.” (Chief Accountant of Praxair, Inc.).

**Exhibit 4 (continued)**

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Cash classified into operating cash flowResponse 1 (fair-value hedge)

“As we reconsidered the classification from the termination of the swap, we determined that since the original intent of the swap was to reduce cash interest costs, which is a component of operating cash flow, the termination proceeds from the swap should be reported there as well.” (Hanger Orthopedic, which changed in 2004 from classification into financing cash flow, Chief Financial Officer).

“There is no specific guidance on termination receipts. We followed the guidance that the benefit or cost of a hedge should follow the item of expense that the hedge is meant to control. In our case we classified the P&L benefit of the hedge, while it was in place, as a reduction of interest expense. It only makes sense that you would follow the same logic on the cash flow of the termination benefit.”

Response 2 (Swaps were not classified as hedges under SFAS No. 133)

“When we terminate an agreement (an interest rate swap), we will either receive a payment or make a payment, which we consider to be part of our cost of operating for the period. While derivatives are considered financial instruments, they are significantly different from our other debt instruments. When we enter into a swap agreement, we do not receive cash proceeds as we do when we issue a debt instrument. During the life of an interest rate exchange agreement the counterparties only exchange the net difference in payment amounts. Each payment period, the company is either a net payer or net receiver based on the terms of the agreement. If the company is a net payer, we consider the amount paid to be an addition to the interest expense paid on debt or our cost of funding for the period. If the company is a net receiver, we consider the amount received to be a reduction to interest expense paid on debt or our cost of funding for the period. When a swap agreement is terminated early, a payment is made between the parties to settle based on the net present value of the current estimate of the future payments that would have been required or the fair value of the position. Thus, the termination settlement payment is similar to the periodic settlements, rather than to the repayment of principal when a debt obligation is retired.” (National Rural Utilities CFC, Chief Financial Officer)

Response 3 (fair-value hedge)

“Under SFAS No. 104 (*Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of SFAS No. 95*), since we classify the interest payments on debt as an operating cash outflow, the cash inflow upon the termination of related interest rate swaps is also classified as an operating activity.”

“In paragraph 40 of SFAS 104, the FASB ‘concluded that cash flows from an interest rate swap intended to effectively convert the interest rate of an asset or liability from variable to fixed or fixed to variable may be classified as operating cash flows consistent with the interest cash flows relating to the underlying asset or liability’”

“There is no specific guidance on the classification of termination receipts or payments. We followed the guidance that the benefit or cost of a hedge should follow the item of expense that the hedge is meant to control. In our case we classified the P&L benefit of the hedge, while it was in place, as a reduction of interest expense. It only makes sense that you would follow the same logic on the cash flow from the termination benefit.” (Textron, SVP and Corporate Controller).

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**Classifying Swap Terminations as Operating Cash Flow: A Recommendation**

Most of the GAAP guidance for the classification of payments and receipts is rather conceptual in nature and leaves much room for the exercise of discretion in decisions about cash flow classification. SFAS No. 95 was motivated in part by concern about the lack of consistency in the classification of cash flows. The Statement has no doubt improved consistency in terms of both the format of the statement of cash flows as well as classification within the three major sections of the statement. However, this study documents a good deal of diversity in the case of the classification of cash flows associated with swap terminations.

Accounting differences do not appear to have an influence on the classification of cash flows from swap terminations. The nature of the swap, i.e. floating to fixed or fixed to floating, determines the hedge classification of the swap: cash flow in the case of floating-to-fixed and fair value in the case of fixed-to-floating. However, the hedge classification of a swap does not predict the classification of cash flows associated with a swap termination. A key role of the FASB is to reduce variations in accounting treatments in the absence of relevant differences in surrounding facts and circumstances. The diversity in the classification of swap-termination cash flows in this study does not appear to be associated with differences in accounting treatment. Therefore, diversity in the classification of swap termination cash flows is not justified.

Our view is that all of the debt-related interest rate swaps are in fact motivated primarily by efforts to manage the effects of changing interest rates. The cash-flow versus fair-value distinction is important for accounting purposes, but it does not and should not determine the classification of cash flows associated with swap terminations. Since interest rate swaps all have the management of interest-rate risk as the ultimate hedge target, we believe that swap-termination cash flows should be classified as operating cash flow. An operating designation is also consistent with the following statement from SFAS No. 95: “Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income”<sup>21</sup> As the earlier coverage of the accounting for swap terminations revealed, all swap-termination payments or receipts eventually pass through the income statement as increases or decreases in interest expense.

In Exhibit 5 we reclassify swap-termination cash flows from financing to operating cash flows for the sample firms in the study that employed a financing designation. These reclassifications have a material influence on operating cash flow in a significant number of cases, resulting in both decreases and increases in operating cash flow. For example, Brookdale Senior Living, Inc. and Wolverine Tube, Inc. saw reported operating cash flow decline by over 80% when swap termination payments were removed. Increases in operating cash flow by over 40% were noted for CBRE Realty Finance, Dominion Homes, Inc. and Texas Industries.

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<sup>21</sup>SFAS No. 95, *Statement of Cash Flows*, (Norwalk, CT: Financial Accounting Standards Board, 1987), para. 21.

**Exhibit 5: Operating Cash Flows Adjusted for Termination Payments & Receipts  
Originally Reported as Financing Cash Flow**

(thousands of dollars)	As Reported OCF	Payment or Receipt	Adjusted OCF	Percentage Change
<b>Payments Reported as Financing:</b>				
Brookdale Senior Living, Inc. (05)	16,900	14,065	2,835	-83.0
Crown Castle International Corp. (06)	275,759	15,274	260,485	-6.0
Healthcare Realty Trust (06)	109,088	10,127	98,961	-9.0
Host Hotels & Resorts, LP (06)	881,000	4,000	877,000	-0.5
Jabil Circuit, Inc. (05)	590,001	4,564	585,437	-1.0
JER Investors Trust, Inc. (06)	30,129	6,113	24,016	-20.0
ONEOK, Inc. (05)	(164,294)	22,565	(186,859)	-14.0
Polo Ralph Lauren Corp. (07)	796,100	4,400	800,500	-1.0
Sanmina-Sci Corp. (06)	(334,303)	29,785	(364,088)	-9.0
Spirit Finance Corp. (05)	54,292	14,984	39,308	-28.0
Texas Industries, Inc. (05)	217,524	6,315	211,209	-3.0
Wolverine Tube, Inc. (06)	1,903	1,700	203	-89.0
Valero Energy Corp. (06)	6,312,000	54,000	6,258,000	-1.0
<b>Receipts Reported as Financing:</b>				
AirGas, Inc. (05)	222,317	3,948	226,265	+2.0
Brandywine Realty Trust (06)	241,566	3,266	244,832	+1.0
CBRE Realty Finance (06)	7,925	3,577	11,502	+45.0
Coca-Cola Enterprises, Inc. (05)	1,619,000	46,000	1,665,000	+3.0
Dominion Homes, Inc. (06)	3,089	2,051	5,140	+66.0
Foundation Coal Corp. (06)	225,654	2,259	227,913	+1.0
Fountain Powerboat, Inc. (06)	2,772	85	2,857	+3.0
Multi Color Corp. (06)	25,276	180	25,456	+1.0
ONEOK, Inc. (04)	240,236	82,915	323,151	+35.0
Salem Communications Corp. (05)	38,903	3,730	42,633	+10.0
Spirit Finance Corp. (06)	99,018	5,825	104,843	+6.0
Texas Industries, Inc. (04)	11,673	8,358	20,031	+72.0
The Stanley Works (05)	362,300	4,600	366,900	+1.0
Waddell & Reed Financial, Inc. (06)	99,559	1,100	100,659	+1.0
Wynn Resorts Ltd. (06)	240,766	6,605	247,371	+3.0

OCF – operating cash flow

## Conclusion

In this research we provide background on interest-rate swaps, including why firms swap interest payments and later terminate those agreements and the essentials of swap accounting, including terminations. We examine the cash-flow classification of payments and receipts from the termination of interest rate swaps. Out of a sample of 44 firms, where the swaps were used for debt-related hedges, the cash payments and receipts were classified into financing cash flow in 25 cases and operating cash flow in the remaining 19 cases. This diversity was not guided by differences in whether the swaps were characterized as fair-value or cash-flow hedges, or by differences in surrounding facts or circumstances.

Analysts and investors should be aware of what appears to be the somewhat arbitrary classification of the cash flows associated with swap terminations. Moreover, standard setters might consider reviewing the diversity in practice revealed in this study and determine whether additional classification guidance is needed. Our own recommendation would be to call for all swap termination payments and receipts to be classified as operating cash flow. This is most consistent with existing GAAP on the classification of hedge-related cash flows and also would remove a source of cash-flow diversity that currently undermines comparability.

If the FASB addresses this cash-flow classification issue, it would be helpful if it also addressed the disclosure of swap-termination proceeds within the statement of cash flows. It was often a challenge to determine whether cash flow associated with a swap termination was reported in the operating or financing sections. The correspondence that was associated with Exhibit 4 did inquire about classifications in the statement of cash flows when there was ambiguity. However, we typically received no response.